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**OGC Has Reviewed**

19 October 1953

MEMORANDUM FOR: GENERAL TAX FILE

SUBJECT : Cost-of-living and Quarters Allowances - Discussion with Mr. Swartz re Hudson Ruling, TC, paragraph 7657, 5 CCH 53.

1. I met Mr. Swartz, Head, Technical Rulings Division of the IRS, today to discuss the Tax Court ruling in the case of *Hudson v. Commissioner* which overruled a disallowance by the Commissioner for deduction of cost-of-living allowances and the value of living quarters as exempt income for an employee of the U. S. Educational Foundation. The Court found that the Foundation was an agency of the Government, but it was not established that the taxpayer was an employee of the Department of State. However, since her payment for quarters and cost-of-living allowances were furnished and paid to her "in accordance with" State Department Regulations, the Court decided that the amounts were properly excluded under the provisions of Code Section 116(j).

2. Code Section 116(j) provides for the exclusion of cost-of-living allowances for employees of the Foreign Service and other civilian officers or employees of the Government staff outside the continental limits of the U. S. (It should be noted that there is no specific reference here to quarters allowances or quarters at Government expense.) Section 116(k) provides for exclusion from taxable income of allowances for employees of the Foreign Service under the terms of Title IX of the Foreign Service Act of 1946. With reference to the 116(j) exclusion, Income Tax Regulation Section 39.116-4 provides in pertinent part that: "Such allowances shall be considered as retaining their characteristics \* \* \* notwithstanding any combination thereof with any other allowance such as a quarters allowance, as, for example, in a 'living quarters allowance,' whether or not such other allowance is excluded from gross income." It seems a logical inference that there might well be some question about the exclusion of an amount for quarters or an allowance in lieu thereof.

3. I asked Mr. Swartz if the ruling were a liberal construction of the requirements and pointed out the Agency interest since the language in our Act was taken from that of the Foreign Service Act. I suggested that the characteristics of the allowances adopted by us could be construed to carry with them the tax benefits accorded by 116(j) or (k). He stated that he did not know at this time whether or not the IRS had acquiesced in the Tax Court decision and was rather interested in the ruling. He will advise me of the IRS reaction to it after he has had an opportunity to inspect the Government briefs.

4. The provisions of Sections 116(j) and (k) should be reviewed with regard to the allowance exclusion not only for employees but also for our so-called "independent contractors." It seems to me that for this purpose the latter, while they are defined in the contract as "not employees" of the U. S. Government, are nevertheless in an employee relationship within the common law definition. If the characteristics of the allowances, including their tax benefits, do not carry over, the taxpayer would have to rely on the "convenience of the employer" rule to justify the exclusion, and this rule is being given a progressively restricted interpretation as the years pass.

STATINTL

[REDACTED]  
Assistant General Counsel